2015 April 13

Via e-mail to Business@Finance.Senate.gov

Finance Committee
United States Senate
Washington DC

Re: Recommendation to Reform the Internal Revenue Code

Dear Senators Hatch and Wyden:

In response to your press release dated March 11 2015, I hereby recommend that the Internal Revenue Code be revised to expand and codify the “check-the-box” Treasury Regulations concerning the classification of business entities for federal income tax purposes.

Current schemes of business taxation. There are three principal schemes under which business entities are subject to federal income tax. First there is Internal Revenue Code subchapter S, which is a pass-through system for which tax items are determined by the percentage of equity held by the owners of the business. The sub S rules are comprehensive, well-coordinated, relatively simple to understand and simple to administer. Second there is subchapter K, which also is a pass-through system. Unlike sub S, however, sub K is a viper’s nest of complexity, despite the surface simplicity of its statutory text. Some types of businesses nevertheless prefer sub K so that the tax items of its equity owners can be manipulated in complex and sophisticated ways. Owners are well advised to retain the services of an experienced – and generally expensive – sub K practitioner in order to avoid the myriad traps for the unwary. Finally there is subchapter C. The revenue derived from the entity-level of tax under sub C is considered to justify its application to enterprises making substantial profits.

Historic primacy of state law form. Back in the day, a business desiring a form of entity was limited to two choices – corporation or partnership. Federal tax law took its cue from the form of entity selected under state law. If a business was incorporated, it was taxed under subchapter C. If it was a state law partnership, it was taxed under subchapter K. It came to be recognized that small, closely held corporations were faced with a difficult choice. If the owners desired the liability protections of corporate form, they were obliged to endure income tax at the entity level. If they desired the more advantageous pass-through treatment under subchapter K, at least one of the partners had to be personally liable for the entity’s debts. Congress responded to that problem by creating subchapter S and making it available to corporations that met stringent ownership requirements.

Limited liability companies and the four-factor test. State legislatures, however, responded to that problem by creating limited liability companies as a new form of entity, designed to bestow liability protection on its owners comparable to that provided by the corporate form, but also achieving the pass-through taxation scheme of the partnership form. The Internal Revenue Service considered LLCs to present an opportunity for abuse and was not prepared to accept pass-through tax treatment for all LLCs by definition. For a while the Service struggled, through public and private rulings, to classify state and foreign variants of LLCs as either corporations for tax purposes, or partnerships for tax purposes, under a cumbersome analysis of four judicially devised factors that purported to signify the presence of corporate characteristics. The opacity and seeming inconsistency of those rulings gave rise to a chorus of complaints by befuddled practitioners and to uncertainty in the taxpaying marketplace.

The check-the-box regulations. The Service finally decided to abandon the antiquated four-factor system and replace it with a system of default and elective classifications. Treasury Regulation sections 301.7701-1, -2 and -3 embody a clever and creative approach to the classification problem of LLCs. For domestic LLCs with a single owner the default entity classification is to be disregarded as being separate from its owner. The subject business, thus, becomes part of the single owner's tax return and is subject to whatever tax system that owner uses. Alternatively, the single owner can elect to treat the LLC as a corporation, in which case it is taxed under subchapter C. For domestic LLCs with more than one owner the default entity classification is as a partnership. Alternatively, the owners can elect to treat the LLC as a subchapter C corporation. The check-the-box regulations thus disconnect the income tax treatment of LLCs from their formal designation under state law. Most LLCs, by default, will be classified in the manner advantageous to most taxpayers.

Proposal. This system works well. Why not extend it to all small and/or closely-held businesses conducted in any entity form? I propose that we untether the tax treatment of all such businesses from their technical classifications under state law. Why should a corporation with a single owner not have the default or elective choice enjoyed by a single-member limited liability company, simply because the relevant state law describes or refers to it as a "corporation" or as "incorporated" as now required by Regulation section 301.7701-2(b)(1)? Why should a small partnership that simply desires to divide its profits and losses according to its partners' distributive shares be subject to the same subchapter K complexities as an investment fund owned by huge corporations and wealthy investors? Would they not prefer the simplicity and coherence of the system enjoyed by S corporation shareholders? To mitigate the impact upon the fisc, retain subchapter C but limit the burden of tax at the entity level by setting a threshold below which only the business owners themselves would be taxed.

Summary. To summarize this proposal: For federal income tax purposes, businesses with only one owner generally would be disregarded as separate from their owners. Federal income taxation thus would be eliminated as a factor affecting the choice of entity, and the owner would be free to select sole proprietorship, corporation, limited liability company or some other form based on the relative benefits and burdens offered by those forms under state law. If the single owner for whatever reason preferred taxation as a separate entity it could so elect.

Most business entities with more than one owner would be taxed under subchapter S by default, again without regard to the state law form of entity. If an entity desired the greater flexibility afforded by subchapter K and was willing to endure its daunting complexities, it could elect to be taxed accordingly.

Finally, business entities of sufficient size to justify tax at the entity level would be required to use subchapter C regardless of whether they technically were corporate entities. The relevant threshold could be set at any one of a number of bright lines. One possibility would be to require the use of subchapter C by all publicly traded entities, a rule that would sweep in publicly traded partnerships.

Ancillary proposals include the following: (1) That this proposal be codified rather than merely regulatory; (2) That existing entities be protected by grandfather rules for a prescribed time; and (3) That flexible rules allow for a relatively painless but non-abusive transition by grandfathered entities to the new system.

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Thank you for the opportunity to contribute to your bipartisan effort “to overhaul the nation’s broken tax code to make it simpler, fairer and more efficient.” I look forward to the results of your work.